The Future of Government: Mixed Economy or Minimal State ?

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Abstract

After nearly a century of expansion, the role of government has contracted, at least in qualitative terms, over the past twenty years. The assumption that this is a natural and inevitable trend is mistaken. The success of the 'mixed economy' in the period from 1945 to 1970, and the limited benefits generated so far by reforms aimed at a contraction of the role of government, suggest that radical contraction of the role of government is unlikely to be beneficial. Some of the privatisations of the recent past will ultimately have to be reversed either through renationalisation or through the establishment of new public entrants to markets where older public enterprises have been sold off.

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Over the past twenty years, many services previously provided by government agencies have been taken over by the private sector. In some cases, government business enterprises have been privatised. In other cases, government funding of services has been maintained, but the provision of services has been contracted out. It is natural to ask where a trend of this kind will, or should, stop. One way of looking at this question is to ask whether there are 'core' functions of government that cannot be undertaken by the private sector. Implicit in this question is an assumption that 'non-core' functions are candidates for privatisation or contracting out. An analysis based on this implicit assumption therefore leads towards a minimal role for government.

The problem of drawing a boundary between the private and public sector is more usefully examined in the historical context of the expansion and contraction of government over the past hundred years. Most goods and services have at one time or another been provided both by the public sector and the private sector. The success of the 'mixed economy' in the period from 1945 to 1970, and the limited benefits generated so far by reforms aimed at a contraction of the role of government, suggest that radical contraction of the role of government is unlikely to be beneficial.

The paper is organised as follows. The first section describes the expansion of government over the century from 1870 to 1970, and the subsequent retreat from intervention. Next, alternative methods of public and private provision of goods and services are described and the costs and benefits of microeconomic reform as it has applied to the government sector are assessed. The claim that contraction of the role of government is an inevitable reaction to developments in the global economy is critically assessed. Finally, issues relevant in drawing the boundaries between the public and private sectors are discussed.

The Advance and Retreat of Government

If we are to say anything useful about the future of government, it is wise to begin by considering the past. As Quiggin (1996a, p. 1) observes:

> In large measure the economic policy program of the past twenty years has been to dismantle the policies introduced in the previous thirty years, and to restore the situation prevailing fifty or even a hundred years ago when the guiding principle of economic policy was laissez faire. Yet there is little interest in finding out why laissez faire policies were felt to be unsatisfactory in the past, or even in any detailed analysis of the strengths and weaknesses of the interventionist policies that replaced them.

Over the century from 1870 to 1970, the role of government grew fairly steadily. The State took over the production and supply of goods and services which had previously been provided, to the extent they were provided at all, by the private sector. Australia, a country settled as an arm of the British government's prison system, led the way in public provision of social welfare services, postal and telecommunications services, railways and roads, universal public education and public health services.

Over the first half of the 20th century, other countries became more like Australia. Whereas Australia's state-owned railways and public utilities were an exception in the 19th century, by the early postwar period it was the United States' insistence on retaining such enterprises in private ownership that looked exceptional. After World War II the early Australian experiments with social welfare systems were matched, and on most measures surpassed, by European welfare states.

The growth of the State from World War II to the 1970s was largely quantitative rather than qualitative, since the boundary between the private and public sectors was fairly stable. Public expenditure grew steadily as a proportion of gross domestic product (GDP) partly because of the increasing importance of sectors such as health and education, where public funding and provision played a large role, and partly because of demographic changes, particularly increased life expectancy, which led to increased expenditure on age pensions. By the 1970s, public expenditure, and the taxation needed to finance it, had reached around 40 per cent of GDP in Australia and more than 50 per cent in many OECD countries. Since much of this revenue was returned to households in the form of transfer payments, the public share of output and employment was lower, but was still around 25 per cent in typical OECD economies by 1970.

The growth of the State was discussed in terms of the 'mixed economy', consciously proposed as a 'third way' between the unfettered capitalism of the 19th century and the comprehensive State socialism of the Communist bloc (Shonfield 1984). The mixed economy involved large-scale government involvement in an economy that was nevertheless predominantly private. The achievements of the mixed economy were substantial. For more than a quarter of a century, unemployment disappeared from the developed world. Economic growth proceeded at rates never equalled before or since. The development of extensive social welfare systems based on progressive taxation led to a reduction in inequality in incomes and an even greater reduction in inequality in living standards.

The most important single factor encouraging the growth of government in the postwar period was the perceived success of Keynesian macroeconomic policies. Keynesian macroeconomic concerns led directly to government intervention aimed at controlling the financial system and stabilising the balance of trade. In addition, the perceived success of macroeconomic intervention generated an intellectual atmosphere in which proposals for microeconomic intervention, based on the notion of market failure, received a favourable hearing.

Debate continues on the reasons for this 'Golden Age' and the factors leading to its breakdown in the 1970s (Marglin and Schor 1990). Simple explanations such as postwar recovery prove unsatisfactory on closer examination, as does the belief, dominant at the time, that prosperity was the direct result of Keynesian policies. Nevertheless, it is important to remember that the longest sustained period of strong growth and full employment in the history of the world economy coincided fairly closely with the period of maximum expansion of government. Although it is possible to argue that this expansion had gone too far by 1970, historical evidence gives little support to advocates of a minimal State.

The breakdown of Keynesian macroeconomic policies in the early 1970s reversed the trend towards growth of government. The apparent success of free-market economists such as Milton Friedman in predicting and explaining the failure of Keynesianism enhanced the prestige of free-market views, though the gloss was taken off this achievement when the monetarist policies proposed by Friedman proved no more successful than the Keynesian policies they replaced. Higher unemployment implied increased expenditure on social welfare benefits and therefore generated pressure to cut back other areas of public spending. Finally, and perhaps most importantly, the loss of confidence in the capacity of governments to control over the economy implied a greater need to cultivate 'business confidence'.

The retreat of the State from provision of public services began with the policy of privatisation initiated by the Thatcher government in the United Kingdom. Whereas previous conservative governments had denationalised some of the acquisitions of their immediate Labour predecessors, the Thatcher government began selling off enterprises such as British Telecom which had been in the public sector since their establishment. Policies of competitive tendering and contracting were designed to encourage private sector provision of publicly-funded services.

The contraction of government in Australia began with the election of the conservative Fraser government in 1975, but proceeded slowly until the mid-1980s. The policies pioneered by the conservative Thatcher government were adopted in Australia, and, with greater enthusiasm, in New Zealand, by labour governments. A number of government business enterprises were privatised, and most others corporatised. Systematic programs of competitive tendering and contracting were introduced. Competition policies were applied to state and local governments.

These trends have continued under the conservative governments of the 1990s. However, with the exception of the labour market, the pace of reform has slowed. In many ways, moreover, labour market reform involves an expansion of the role of the State, with the creation of a range of new criminal and civil offences, and the revival of old common law causes of action. The main difference is that the government is explicitly on the side of employers, rather than adopting the position of a neutral arbiter.

In qualitative terms, the contraction of government over the past twenty years has been striking. The quantitative change in the ratios of government expenditure and taxation to GDP has been much less dramatic. This is primarily because the trends which led to expansion of the public sector over the postwar period have continued. Demand for services such as health and education, traditionally provided by governments, have grown. Demographic changes, reinforced by high unemployment, have increased the demand for transfer payments. Thus, in the absence of some transfer of activities from the private to the public sector, growth in the public sector share of GDP would have continued, and perhaps accelerated.

The idea of 'State capacity' (Mann 1988) is useful in understanding the growth and contraction of government. Contrary to exaggerated claims about the effects of technological change and globalisation, the State retains a substantial capacity to intervene effectively in the economy (Weiss 1998). However, that capacity has not grown in line with the demands implied by the range of responsibilities taken on by governments in the postwar period.

Public and Private Provision of Goods and Services

As Australian history shows, almost any good or service can be provided by government. The first farm in Australia was the Government Farm on the site of the present Botanic Gardens in Sydney. It was not a success. Another unsuccessful venture was the Queensland government's establishment of publicly-owned butcher shops in the 1920s. Public provision of infrastructure services such as postal services, telecommunications and electricity was more successful.

Just as there are no inherent limits to the scope of government, there are few activities which can be regarded as 'core' services in the sense that they can only be provided by government. The distinction between core and non-core functions is useful in the analysis of choices between contracting out and in-house provision of services by individual enterprises, including government business enterprises and other public agencies. Individual agencies have relatively well-defined objectives, which make the concept of core functions meaningful. This is not true of government as a whole.

Almost any task undertaken by government can be, and has been, undertaken by private enterprises. For example, the transport of convicts to Australia was undertaken primarily by private contractors. However, the First Fleet was effectively a public venture, being under the direct control of Governor Philip, while the Second Fleet was controlled by the contractors, paid on a fixed rate per convict. As a result of the incentive to skimp on food and medical attention, around a quarter of the convicts in the Second Fleet died, and half were unfit for work when they arrived (Clark 1962) whereas the death rate for the First Fleet was minimal.

Similarly, both police and military services can be, and have been, privately provided. Until the 19th century, reliance on mercenary troops was the rule rather than the exception in European wars. However, the crushing defeats experienced by mercenaries at the hands of French and American citizen armies led to the abandonment of this practice. Recent experience, such as that of European mercenaries employed by the Mobutu government in Zaire (now Congo) reinforces the point that private provision of military services is rarely satisfactory. More recently, private prisons have been revived, along with many of the problems of abuse of power and lack of accountability that led to their abandonment in the 19th century (Moyle 1994)

As these examples illustrate, government enterprises perform poorly in some areas, while private enterprises perform poorly in others. The existing distribution of activities between the public and private sectors is, in large measure, the result of learning from historical experience. Following the experiments of the early part of this century, governments have largely withdrawn from small-scale enterprises, such as butcher shops. On the other hand, governments in Australia and most other countries took over the provision of a range of infrastructure services such as rail transport, postal and telecommunications services, where private operators had failed. Thus, the existing allocation of activity between the private and public sectors is not purely haphazard, as much discussion has tended to imply.

1.1 Quangos and Qangos

It is important, also, to remember that the boundary between the public and private sectors is not sharp. Between the extremes of a government department and a private firm operating in lightly regulated competitive markets, there is a range of intermediate possibilities, which may be generically referred to as 'quangos' or 'qangos'.

The term 'quango' has a curious history (Wettenhall 1981). Once, there were only NGOs -- non-government organisations like the Australian Council of Social Service or the Returned Services League. However, it was observed that many so-called NGOs were closely tied up with government, often operating in symbiotic relationships with the government agencies with which they regularly dealt. In addition, particularly in the United States, there has been a practice of creating nominally private business organisations, with effective government backing, to perform what would normally be regarded as public functions. The Federal National Mortgage Association ('Fannie Mae') is an example. The term 'quasi-NGO' or 'quango' was coined as a mildly pejorative description of these hybrids.

When economic reformers in Britain, and later in Australia, wanted to cut back the profusion of statutory authorities, they decided to appropriate the term to their own use. Unfortunately the acronym didn't quite fit. Statutory authorities could reasonably be described as quasi-autonomous governmental organisations, but there was no easy way to use the letter 'N'. Eventually they settled on 'national'. This was logically redundant in the United Kingdom and simply incorrect for Australia where most statutory authorities are run by state governments, but it worked. Some users took the process to its logical conclusion by dropping the 'U' and writing about 'qangos'.

The reform of government is turning qangos (in the new sense) into quangos (in the old sense). When a government business enterprise such as a water authority is privatised, the result is frequently not a competitive firm, but a monopolist with profits determined more by government policy than by market performance. Such enterprises typically require close regulation to prevent exploitation of consumers. At the same time, they are so vulnerable to adverse policy decisions that buyers typically require advance guarantees of a favorable policy climate. Finally, the services provided by such firms are often such that they are 'too important to fail'. If such enterprises run into financial difficulties the government has no alternative but to bail them out. The term 'quango', in its original sense, has never been more appropriate than as a description of these quasi-private enterprises performing governmental functions.

Explaining the Expansion and Contraction of Government

As was noted above, the fact that some activities have, until recently, been undertaken by the public sector and others by the private sector reflects the lessons learned from past experience. This is not to say that the current allocation of roles is ideal. Some activities are undertaken (or not) by the public sector as a result of past mistakes or of random events, such as emergency decisions to rescue failing private enterprises. Moreover, technological change or innovations in organisational design may undermine old rationales for public provision of goods and services, or create new ones. Finally, developments in economic analysis may lead to systematic changes in estimates of the costs and benefits of public provision.

The role of mistakes and random factors is relatively unimportant. However, the process of correcting past mistakes is not symmetrical. When the State was expanding, there was pressure for intervention in areas of inadequate public provision, such as health insurance, while government enterprises that had been acquired by accident, such as military clothing factories, were retained out of inertia. Conversely, in the current period, governments have been quick to abandon public enterprises which are seen to have outlived their usefulness, but much slower to extend public provision in areas, where its absence is anomalous, such as in support for dental services.

It has often been argued that technological change in infrastructure industries has rendered concepts such as natural monopoly obsolete, and thereby removed the rationale for public provision. In most cases, these claims reflect wishful thinking rather than serious analysis. Although technological change has eliminated some old natural monopolies, it has created new ones. For example, until recently, local telephone services were regarded as natural monopolies, since it is inefficient to supply two sets of cables to serve the same residential district. The development of optical fibres and of cellular mobile phone networks, based on analog and digital technologies changed this situation fundamentally. The availability of mobile phones implies the possibility of competition between analog mobile, digital mobile and fixed telephone networks and therefore reduces the extent to which the telephone market as a whole can be described as a natural monopoly. However, each of these three technologies, considered individually, has the standard characteristics of natural monopoly. Moreover, since optical fibres have the capacity to transmit large quantities of data, including TV signals, the potential scope of natural monopoly has actually been extended by technology.

The willingness of policy-makers to adopt the comforting belief that natural monopoly is an obsolete category was a major factor in the continuing fiasco of Australian telecommunications policy. A mistaken desire to promote competition between firms, rather than between technologies has resulted in the construction of two half-finished optical fibre networks, three half-finished digital mobile networks, and the compulsory closure of the analog network which still provides the best service for most of the country, in part because it was constructed as a single network with common carrier access. Obviously, none of these outcomes would have occurred had the public monopoly, in operation until the passage of the Telecommunications Act 1991, been maintained.

Changing ideas about the relative efficiency of the public and private sectors were the main force behind the expansion of public sector provision in the century before 1970, and they have been the main force behind the contraction of public sector provision since then. However, as Keynes observed long ago , the ideas of intellectuals tend to affect policy with a considerable lag. Keynes' own ideas, developed in the 1920s and 1930s, had little influence on policy during his own lifetime, and only became the policy orthodoxy in the 1950s and 1960s.

The same lag is evident at present. The main intellectual developments of the 1970s, including rational expectations theory, contestable markets analysis, property rights theory and public choice theory, were critical of existing government policies and supportive of a return to the classical policies of laissez faire. By contrast, the main developments of the 1980s and 1990s, including strategic trade theory, the theory of contracts, endogenous growth theory and new Keynesian macroeconomics, tend to undermine faith in the optimality of market outcomes without, however, prescribing simple remedies in the form of interventionist policy programs. Krugman (1990) gives an excellent survey of the rise and fall of 'new classical' ideas. The enthusiasm for market solutions which swept much of the economics profession in the 1970s now dominates the circles where policy is formulated and implemented. The more critical views developed by economists in response to theoretical and empirical problems with the free-market approach have yet to influence policy.

Evaluating Reform of Government

Both during the expansion of the State and during its subsequent contraction, most discussion of the role of government has been based on myths of the Left and Right, rather than on any objective assessment of costs and benefits. When government was growing, socialists and social democrats regarded any expansion of public sector activity as desirable per se, without considering whether the private sector alternative could deliver a better quality of service at a lower cost or whether the benefits of public provision were equitably distributed. Similarly, during the period of public sector contraction, evaluation of government policies has focused on the question of whether these policies are in agreement with anti-government orthodoxy, rather than on whether desirable economic outcomes are being achieved.

The contrast is most evident in relation to discussions of New Zealand. In terms of the current policy orthodoxy, recent New Zealand governments are seen as having done everything right. A country which in 1984 had one of the most interventionist governments in the OECD now has one of the least interventionist. Glowing accounts of the New Zealand model are common, not only in the popular press, but in leading economic journals (Evans et al. 1996).

In terms of outcomes, however, New Zealand looks far from successful. Growth in GDP has been well below the OECD average since the commencement of reform in 1984. Whereas New Zealand's GDP per capita was about 10 per cent below that of Australia in 1980, it is now more than 20 per cent lower (OECD, various years). The contrast with Australia is particularly striking in view of the fact that flows of goods, services, people and capital between the two countries are almost completely unrestricted under the Closer Economic Relations agreement which came into force in 1983. Such a situation would normally be expected to promote convergence in incomes rather than the divergence that has been observed.

Similarly poor outcomes have been observed in New Zealand with respect to employment levels, the current account deficit, and the growth of poverty and inequality (Easton 1997). Until recently, defenders of the New Zealand reforms could point to a reduction in the unemployment rate, which fell to 6.1 per cent in 1996. However, this reduction proved to be as short-lived as the economic expansion of the early 1990s. Unemployment is now back to 8 per cent, and is expected to remain at or above this level throughout 1998-99 (New Zealand Treasury 1998).

Economic Performance in Australia

In Australia, it is possible to compare predictions of the benefits of reform of government with actual outcomes. Kasper et al. (1980) presented scenarios illustrating the benefits of a proposed free-market strategy, which they called the libertarian path, relative to a base scenario involving minimal change, which they referred to as the mercantilist path. For the base scenario, Kasper et al. projected real annual GDP per capita growth of 1.7 per cent over the period 1973-2000. For the libertarian alternative, Kasper et al. projected real annual GDP per capita growth of 3.8 per cent over the period 1973-2000, implying a cumulative gain of 77 per cent relative to the base scenario. In fact, even though most of the reforms advocated by Kasper et al. were adopted during the 1980s, the rate of growth of GDP per capita has been almost exactly equal to that projected in their base scenario.

Beginning with the Industries Assistance Commission (1989), a number of model-based estimates of the benefits of microeconomic reform have been generated (Industry Commission 1990, 1995, 1996; Business Council of Australia 1994; Bureau of Industry Economics 1990; Filmer and Dao 1994; Dao and Jowett 1994). Although a range of market-oriented reforms was considered, the primary focus was on reform of government business enterprises. The projected benefits ranged from 5.5 per cent of GDP (Industry Commission 1995) to 21 per cent (Bureau of Industry Economics 1990; Business Council of Australia 1994). In most studies it was suggested that this increase in GDP would be achieved over five to ten years. Quiggin (1997a) presents a critique of the Industry Commission (1995) and derives alternative estimates of the benefits of the set of microeconomic reforms referred to as 'Hilmer and related reforms'. These estimates span the range from 0.75 to 1.1 per cent of GDP. Assuming this gain is realised over a five-year period, the estimates in Quiggin (1997a) imply an increase in the trend rate of GDP growth of between 0.15 per cent of GDP and 0.22 per cent of GDP.

Economic performance since the contraction of government began has been disappointing, to say the least. Far from improving, productivity growth slowed during the 1980s (Dowrick 1990), particularly in the private sector. Although allocating observed productivity growth to factors of production is a problematic exercise, a number of writers concluded that the slowdown in productivity growth was the result of zero or negative growth in capital productivity. Supporters of microeconomic reform argue that the low growth of capital productivity during the 1980s may be attributed to the 'teething problems' of financial deregulation and to sequencing problems, particularly the fact that product and capital markets were deregulated but labour markets were not. By contrast, critics argue that the reforms themselves were misconceived and that no significant improvement in productivity can be expected to arise from them.

The experience of the 1990s is crucial in resolving this debate. Advocates of microeconomic reform such as the Industry Commission (1997) have claimed that reform has led to an increase in the rate of productivity growth. However, it is very difficult, in the short term, to distinguish between changes in the underlying rate of productivity growth and temporary cyclical fluctuations. The normal procedure is to make comparisons between pairs of years, both of which represent the end of one cycle and the beginning of another. Since the upswing that commenced in 1992 has not yet ended, it is not yet possible to make a definite judgement as to whether an improvement in the rate of growth of productivity has taken place.

The Industry Commission (1997) estimates that the rate of multi-factor productivity growth in the market sector has risen from 1.5 per cent, the average rate since the 1960s, to a trend rate of 2.0 per cent in 1994-95 and 1995-96. Some, but not all, of this increase is acknowledged to be cyclical. Since the market sector accounts for about 60 per cent of GDP, a productivity improvement of 0.5 percentage points is equivalent to an increase of 0.3 per cent in the trend rate of GDP growth. Over a five-year period, this yields a total gain equal to 1.5 per cent of GDP, slightly higher than the upper-bound estimate presented by Quiggin (1997a), but well below any of the other estimates mentioned above, even allowing for ambiguity in the time-frame.

If some of the extra growth is assumed to be cyclical and some to represent a recovery from the below-trend productivity of the 1980s, with the remainder being attributed to microeconomic reform, the evidence reported by the Industry Commission is consistent with the estimates of benefits presented by Quiggin (1997a), namely, a net improvement in GDP of between 0.7 and 1 per cent of GDP over five years, which would not be sufficient to generate an observable change in the rate of growth of GDP in the medium term.

Case-by-Case Evaluation

In the absence of any clear evidence that reform of government has generated an improvement in the economic performance of the economy as a whole, it may be useful to look at individual cases. Even at this level, it is hard to draw clear conclusions. Official estimates of the benefits of microeconomic reform, including reform of government, have been consistently over-optimistic. For example, the widely-cited estimate that airline deregulation has reduced air fares by 20 per cent (Bureau of Transport and Communications Economics 1994) rests on a failure to take into account the shift in product mix towards discount fares sold under restrictive conditions. A properly-calculated price index for airline services fell by about 1 per cent as a result of deregulation (Quiggin 1997b).

Similarly, the Industry Commission (1996) claimed that a reduction of the general tariff rate from 5 per cent to zero, along with the removal of higher levels of protection for the motor vehicle and clothing industries would yield benefits equivalent to 1 per cent of GDP. Application of basic techniques for the analysis of economic welfare, such as the Harberger triangle technique for estimating consumer surplus, suggest that the likely benefits are well below 0.1 per cent of GDP (Quiggin 1996a). During the inquiry into assistance to the motor vehicle industry, criticism of this kind led the Industry Commission to substantially reduce its estimates of the benefits of tariff reform.

Moreover, there is general agreement that some policies, promoted as examples of microeconomic reform, have been economically harmful. For example, Build, Own, Operate and Transfer (BOOT) schemes for the construction of roads have proved to be more costly than the traditional alternative of publicly-owned roads financed by the issue of debt and constructed after a process of competitive tendering (Economic Planning Advisory Commission 1995a,b; Quiggin 1996b; Hepburn et al. 1997; House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform 1997). Similarly, with the possible exception of the Australian Competition and Consumer Commission, few now support the view that physical duplication of telecommunications infrastructure is an appropriate alternative to provision of infrastructure by a publicly-owned or publicly-regulated monopoly, at least for local services.

On other issues, such as the privatisation of government business enterprises, there is no agreement. Many supporters of privatisation appear to believe that any asset sale yielding a positive price is beneficial, while much opposition is based on purely emotive arguments. At one point a consensus appeared to be emerging that privatisation was justified if the interest savings from debt repayment exceeded the foregone earnings of publicly-owned firms. However, this consensus collapsed when it became apparent that hardly any of the privatisations of recent years pass this test (Quiggin 1995). The current debate turns on complex issues relating to the valuation of public and private sector risk (Hathaway 1997; Quiggin 1997c).

The main lesson that can be learned from experience so far is that policies based on a dogmatic preference for private provision of goods and services will be no more successful than policies based on a dogmatic requirement for public ownership. There is a range of activities where public sector provision is more efficient, but there is, as yet, little agreement on where the boundary between the private and public sectors should be drawn.

Effects on Governance

The term 'governance' is used to describe the processes by which institutions, including governments and corporations, are made accountable to those whom they are supposed to serve, such as citizens or shareholders. The period of expansion of government was also, in general, one of improvements in governance. The growing role of the State necessitated innovations in organisational design and improvements in accountability.

The development of statutory authorities provided an organisational form for the production and provision of goods and services by government. Decision-making processes within statutory authorities were less rigid than in the traditional public service, since day-to-day decisions were the responsibility of the board, but they were nevertheless ultimately responsible to governments. The biggest single achievement of the statutory authority model arose with the replacement of the Postmaster-General's Department by two statutory authorities, Telecom Australia and Australia Post, dealing with telecommunications and postal services respectively. This change led to substantial productivity gains, considerably larger than those associated with subsequent corporatisation (Industry Commission 1992).

There was also an increase in the responsiveness of government agencies to individuals aggrieved by the actions or decisions of those agencies. One important change was the abolition of the doctrine that 'the Crown can do no wrong', under which government agencies were immune from legal action. A later innovation was the adoption of Freedom of Information policies and the development of avenues of redress such as the Office of the Ombudsman for those unfairly affected by administrative decisions.

Despite these improvements, the growing importance of government rendered the need for better governance more urgent. Free-market critics of the expanded role of government made some important contributions to the debate over governance, mostly centred on the concept of 'transparency'. This concept was used to express the idea that government policies should be directed to the achievement of specific, sharply-defined objectives, rather than being justified in terms of a broadly-defined notion of the public good.

The growth of government had led to the use of a wide range of policy instruments for diffuse purposes, making it difficult to evaluate the costs and benefits of any particular intervention. Advocates of 'transparency' sought to clarify the objectives of government agencies, and to require that, if policies were justified in the name of particular objectives, they should be funded out of the relevant budget. For example, if otherwise uneconomic road or rail links were justified on defence grounds, they should be subsidised out of the defence budget.

The idea of transparency was used to justify the replacement of statutory authorities, whose managers had a general objective of promoting the public interest, with corporatised enterprises directed to maximise profits subject to the satisfaction of specific 'Community Service Obligations' (CSOs). In particular, unless cross-subsidies between classes of consumers were explicitly required as CSOs, they were to be removed. A related policy was based on the idea of a 'purchaser-provider split', that is, a separation between the agencies responsible for funding the provision of services to the public and the government agencies or private firms responsible for actually providing the services.

The movement towards transparency yielded some improvements in governance. However, dogmatic application of concepts such as that of the purchaser-provider split frequently proved counterproductive. Both in the private and in the public sector, there are many cases where a sharp distinction between purchasers and providers is not feasible.

In any case, the appeal of transparency was short-lived. As long as microeconomic reform was perceived as making governments more efficient and accountable, transparency was desirable. This situation changed with the advent of contracting out, privatisation and corporatisation, which replaced government agencies with private business or with publicly-owned corporations run on private business lines. The traditions of business are those of secrecy and confidentiality, rather than of transparency. As governments sought to become more businesslike, the concept of 'commercial confidentiality' was invoked with increasing frequency to justify the preservation of secrecy about transactions.

Standards of governance have declined as government has become smaller and more 'businesslike'. The rise of commercial confidentiality as a justification for secrecy has been accompanied by the replacement of an independent public service by appointments based on political patronage. Attacks on the role of Auditors-General have also been part of the process. Related to this has been an increasing tendency for former politicians and public servants to find high-paying jobs in the business sector, raising the possibility of the return of favours granted in office. All of these changes enhance the potential for large-scale corruption. Most played a role in the extensive system of corruption known as WA Inc (a name which is revealing in itself).

The problems with attempts to make public agencies more like private businesses may be analysed using Hirschman's (1970) distinction between 'exit' and 'voice'. Consumers in a competitive market who are dissatisfied with the quality of service from some particular supplier have the option of exit, that is, of choosing another supplier. Similarly shareholders who feel that their company is being mismanaged can voice their concerns, for example by voting for new directors, but normally find it simpler to exit, by selling their shares. By contrast, where unsatisfactory services are provided by a government agency, it is necessary to resort to voice, through complaints to the local member of parliament, the Ombudsman and so on.

Free-market reform is based on the presumption that exit is more effective than voice, or, as it is more frequently stated, that market discipline is more effective than political processes. In the case of services provided by a single private firm, consumers have neither voice nor exit options. In most cases where provision of public services has been handed over to a private supplier, various contingent liabilities and obligations remain with the public, but the actions of the provider (and of the government acting as purchaser) are protected from scrutiny by commercial confidentiality. Thus members of the public are in a position analogous to that of 'locked-in' minority shareholders who can neither sell their shareholding nor control the incumbent management.

Do we Have a Choice ?

The success of the push for reforms aimed at winding back the expansion of government rests in large measure on the belief that, in Thatcher's words: 'There is no alternative'. In contrast with earlier claims that reforms were desirable because they would generate improvements in economic performance, Thatcher argued that, in the absence of reform, economic breakdown and declining living standards were inevitable.

Three versions of this argument have been presented in the Australian debate. The first is based on the idea that failure to undertake reform will lead to a continuing decline in living standards relative to those of other countries in the region. The second is based on the idea that the integration of international markets for goods and capital, commonly referred to as 'globalisation', has eliminated the capacity of governments to act independently. The third argument may be described as the 'argument from fashion', namely that since most other countries are pursuing policies of privatisation and contraction of government, Australia should do likewise. This argument may be refuted by the simple observation that, in the 1950s and 1960s, Australia and most other countries pursued policies of nationalisation and expansion of the role of government. This simply reflects the fact that policy ideas spread rapidly, whether or not they are correct. The fact that a given policy is adopted in many countries does not prove that it is a good one. Attention will therefore be focused on the first two arguments.

Relative Living Standards

A number of writers including Henderson (1990, 1994) and Kelly (1992) argue that free-market reform in Australia is needed because our economic performance has been poor compared to that of other nations. A typical presentation of the argument is that of Clark (1995, p. 145) in a section entitled 'Why microeconomic reform is unavoidable':

In the 1880s, Australia led the world in the productivity of its labour force. According to one estimate, our labour productivity was over 50 per cent higher than that of our nearest competitors, the US and UK. The result was the highest standard of living in the world. Since then, we have fallen further and further behind in the international economic race, largely because of insufficient structural change and productivity growth below that of most other western economies.

Some observers, such as Hughes (1985), extrapolated from this argument to suggest that, in the absence of radical changes in economic policies, Australians would soon become the 'poor white trash' of South-East Asia, and that Australia would be reduced to the status of a client state of its Asian neighbours. In particular, it was claimed, Australia needed to emulate the low tax rates and business-friendly policies of South-East Asian governments. The claim that Japanese living standards had surpassed those of Australia, and that the gap was widening, was particularly influential as a demonstration of Australia's poor economic performance. (Advocates of active industry policy also pointed to Asian models, but their arguments have had little impact in the Australian policy debate.)

in reality, the claim that Australians in the 1880s had the highest living standards in the world is based on misleading population statistics rather than a meaningful comparison of economic performance (Quiggin 1987). Furthermore, when hours of work are taken into account, average Australian living standards in 1990 were unambiguously superior to average Japanese standards (Dowrick and Quiggin 1993), although there are difficulties arising from the need to distinguish between leisure and involuntary unemployment.

Arguments based on naive extrapolation of the performance of Asian countries during the 'catch-up' phase of economic development have lost further credibility as a result of the Asian economic crisis. However, many of those who previously pointed to the Asian economies as models now claim that the difficulties experienced by those economies simply show the need for further free-market reform in Australia.

A more fundamental objection is that, at least within the range observed for the developed countries, differences in relative income are too small to have the kinds of effects postulated by advocates of the 'poor white trash' thesis, such as a loss of national independence. For example, the fact that average incomes in New Zealand are around 20 per cent lower than those in Australia (a gap which has widened since the introduction of radical free-market reforms in New Zealand) may motivate individual New Zealanders to emigrate to Australia but it does not turn New Zealanders into 'trash', or make New Zealand a less free and independent country than Australia.

Globalisation

The idea that global market forces cannot or should not be resisted is an old one. Hancock's classic study Australia, first published in 1930, included the following observation (Hancock 1961, pp. 66-7):

The Australians have always disliked scientific economics and (still more) scientific economists. They are fond of ideals and impatient of technique. Their sentiments quickly find phrases and their phrases find prompt expression in policies. What the economists call 'law' they call anarchy. The law which they understand is the positive law of the State -- the democratic State which seeks social justice by the path of individual rights. The mechanism of international prices, which signals the world's need from one country to another and invites the nations to produce more of this commodity and less of that, belongs to an entirely different order. It knows no rights, but only necessities. The Australians have never felt disposed to submit to these necessities. They have insisted that their governments must struggle to soften them or elude them or master them.

It is frequently argued that changes in technology, such as improvements in communications have reduced the capacity of governments to 'soften, elude or master' the demands of the world market. In fact, however, world trade and capital flows were larger in relation to world output and investment in 1900 than they are today. Restrictions on trade and investment led to a reduction in global economic integration between 1914 and 1950. Since 1950, and especially since the breakdown in 1972 of the Bretton Woods agreement which regulated international financial relationships, integration has increased and is now approaching the levels of the 19th century. However, it is important to recognise that globalisation is primarily the result of policy changes, and not vice versa.

The removal of restrictions on capital flows has increased the importance of international capital markets and has thereby constrained governments in important respects. In general, the profitability of international financial transactions is determined by the risk that borrowers will default on loans and by changes in the relative value of different currencies, which, in the long term, depend on differences in inflation rates. Hence, if governments pursue policies that are perceived to be inflationary or to increase the risk of default, the currency will depreciate and international lenders will demand higher interest rates. Thus, globalisation has increased the importance of 'sound money'.

Defenders of globalisation argue that the effect of active currency markets is merely to reduce the interval between the adoption of inflationary policies and the resulting acceleration in inflation. On the other hand, it has been widely suggested that the globalised economy has a deflationary bias with an increased likelihood of severe recession.

Increases in the mobility of capital have also constrained the ability of governments to levy taxes on capital income. Arguably, this enhances the desirability of public ownership of business enterprises, which permits governments to appropriate capital income directly in the form of dividends from, and growth in the capital value of, public enterprises.

On the other hand, access to world capital markets has increased the flexibility of governments in other ways. When capital flows were restricted, sustained government deficits would lead to a rise in domestic interest rates and 'crowding out' of private investment. Similarly, sustained current account deficits would lead to exhaustion of reserves of foreign exchange. By contrast, provided the confidence of capital markets is maintained, it is now possible to run current account deficits for long periods.

In addition to these long-term effects, the growth of financial markets has short-term effects arising from the incentives for certain forms of herd behaviour. One result is the frequency of market fads and speculative bubbles. Another is, that, in the short run, financial market outcomes reflect the prejudices of traders rather than rational judgements about future inflation rates. Thus, for example, financial markets may react negatively to interventionist policies, such as expansion of public sector production, even if they do not have any inflationary implications. However, this can only be a short-term phenomenon. The desire of market participants to maximise profits means that, in the long term, exchange rates and interest rates are determined solely by relative prices.

In summary, although the breakdown of restrictions of international capital flows imposes new constraints on government policy, globalisation does not imply that governments must adopt free-market policies. The relevant criterion, now as in the past, is that governments should pursue policies if and only if the benefits of those policies outweigh the costs.

Drawing the Boundaries

The discussion presented above suggests that complete withdrawal of the public sector from the production of goods and services is unlikely to prove economically efficient. How, then should the boundary of the private and public sectors be defined?

Quiggin (1996b) suggests five criteria which may be used in assessing the suitability of a given activity for allocation to the private or public sector (Table 1). In each case, the criterion is written as a pair of alternatives, which define a range, for example, from a purely competitive market to a natural monopoly. The closer a given enterprise is to the end of the range defined by the first of the alternatives the more suitable it is for private ownership.

Table 1 Characteristics which Determine the Suitability of an Enterprise for Location in the Private or the Public Sector

The arguments for and against public ownership in cases of natural monopoly, market failure or a need for subsidised provision have been canvassed extensively, for example by Kay and Thompson (1986) and Domberger and Piggott (1986). In particular, there has been extensive analysis of a range of economies of scale and scope which result in market structures intermediate between perfect competition and natural monopoly (Baumol, Panzar and Willig 1982). There is also a large literature debating the role of subsidised public provision of goods and services in income redistribution (Albon 1991; Quiggin 1997d).

There has been rather less attention paid to the role of risk in determining the appropriate allocation of activity to the public and private sectors. The argument that economy-wide risk is best handled by the public sector was first put forward by Arrow and Lind (1970), and is presented, in a revised form, by Grant and Quiggin (1998). Critiques of this argument have been offered by Bailey and Jensen (1972) and Hathaway (1997), among others.

The view that risk arising from government regulation is best handled through public ownership is now widely accepted. This acceptance has been reflected in a broad consensus that in the case of road projects, where the main source of risk arises from the regulation of the road network as a whole, public ownership of roads is to be preferred to Build, Own, Operate and Transfer (BOOT) schemes (Economic Planning Advisory Commission 1995a,b; Quiggin 1996b; Hepburn et al. 1997; House of

Representatives Standing Committee on Communications, Transport and Microeconomic Reform 1997). Regulatory and systematic risk are most significant in relation to capital-intensive enterprises. By contrast, much of the free-market critique of public enterprise is based on the claim that such enterprises use labour inefficiently (Beesley 1992). Hence, the more capital-intensive an enterprise, the more suitable it is, other things being equal, for public ownership.

The desirable size of the public sector will depend in part on the extent to which the characteristics of major economic activities make them suitable for private or public provision. It is also necessary to consider arguments about the size of the public sector relative to the economy as a whole. For example, as the ratio of tax revenue to national income rises, the marginal cost of raising additional revenue also tends to rise, and therefore so does the social cost of a subsidy to any given activity. It is possible, therefore, that an activity which is appropriately located in the public sector when the ratio of tax revenue to national income is small may be more appropriately placed in the private sector when the ratio of tax revenue to national income is large.

Neither the characteristics of economic activities, nor the constraints on the share of the public sector in national income are static. Economic growth has been accompanied by an increase in the importance of activities, such as the provision of health, education and infrastructure services, where the public sector, for one or other of the reasons listed above, has historically played a major role. Moreover, as related services such as aged care have become more costly and have become more reliant on professional skills, there has been increasing demand for governments to play a role in funding or providing these services.

On the other hand, the growth of international financial markets has reduced the capacity of governments to tax capital income and has tightened the constraints on the share of the public sector in national income. This conflict between the increasing demands on government and its constrained capacity to meet these demands has been called the'fiscal crisis of the State' (O'Connor 1973). The questions of the extent to which O'Connor's analysis is applicable to developed countries in general, and of whether the term 'crisis' is appropriate to describe what now appears to be a chronic problem, are discussed by Pierson (1991), Quiggin (1998) and Saunders (1998).

A satisfactory response to the fiscal crisis of the State requires action to increase the revenue-raising capacity of government while improving the efficiency with which revenues are raised and spent. Properly-designed programs of public sector reform will play a role in formulating such a response, but an ideological preference for the private sector will not.

Concluding Comments

After nearly a century of expansion, the role of government has contracted, at least in qualitative terms, over the past twenty years. Functions which were taken over by government because of the perceived inadequacy of private sector provision are now being handed back to the private sector as a response to the perceived failure of public sector provision.

The present contraction of government, like its expansion between 1900 and 1970, is driven at least as much by ideological enthusiasm as by rational analysis. Correction of the resulting mistakes will require reregulation of areas of the economy where inappropriate deregulation has taken place. Similarly, some of the privatisations of the recent past will ultimately have to be reversed either through renationalisation or through the establishment of new public entrants to markets where older public enterprises have been sold off.

The determination of the appropriate boundaries of the public and private sectors is not an easy task. An attempt to tackle the problem by identifying 'core' functions of government yields the unhelpful result that there are no core functions that cannot be undertaken by the private sector, and similarly, no activities in which public sector provision is wholly infeasible. A comparison of costs and benefits is necessary in every case.

Overall, however, there is a striking contrast between the success of the 'mixed economy' in the period from 1945 to 1970, when the expansion of government was at its peak, and the disappointing performance of earlier and later periods. The best hope for a return to the strong economic performance of the postwar boom lies in an economy with a reformed, but still substantial, government sector.

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